ECONOMIC PERSPECTIVES

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— A PERIODIC COLUMN OF VICE CHAIRMAN SAXTON'S VIEWS OF CURRENT ECONOMIC AFFAIRS —

MARKET TURBULENCE AND FED POLICY

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The Federal Reserve's recent policy moves raise three concerns despite the Fed's outstanding efforts in controlling inflation and perpetuating the current record-breaking expansion. The first relates to the inherent uncertainties associated with the implementation of monetary policy. Federal Reserve policy actions impact the economy with lags that are "long and variable." Given the six interest rates increases (of 175 basis points) that have occurred in recent months, there are risks of adding further to a tightening "already in the pipeline" and therefore of bringing about an unanticipated slowdown and associated market turbulence. With a number of signs of an imminent slowdown impacting interest sensitive sectors of the economy, caution should be the prudent guide for policy at this time.

A second concern relates to the choice of policy guides. Even if there is little disagreement over a price stability policy objective, different policy guides (or intermediate indicators) can be used to advance this objective. The choice of these guides can make a significant difference in economic results. Of late, the Federal Reserve seems to be increasingly employing real economic variables such as labor market variables or measures of real economic growth (relative to estimates of potential growth) as guides to policy. Frankly, these approaches are reminiscent of discredited Phillips curve views of policy actions. Such real policy guides can prove to be unreliable, especially in an era of significant technological change; notice that the unemployment rate and core inflation rate have generally declined <u>together</u> for more than eight years. In short, recent explanations of policy action seem to be less and less price or inflation based.

The emphasis on and use of these policy guides related to labor markets or total output appear to have encouraged expectations of several additional rate increases to build-into various financial markets. Yet it is not at all clear that such increases actually will be needed. If they are not, subsequent release of weaker-than-expected economic data will cause these expectations to reverse themselves and back out of the market. The end result is significantly increased market volatility that is both unnecessary and costly. Yet this turbulence is largely avoidable since better guides are available. These better guides are based on market prices.

Such alternative price-based approaches do not seem to justify the expectations of several more rate hikes that currently appear to be built into the markets. Indeed, in recent years market price-based intermediate indicators (such as commodity prices and exchange rates) have been more accurate in signaling future price pressures than the real or labor market variables currently emphasized by the Federal Open Market Committee. This is not surprising since such market prices conceptually are more directly related to movements in inflation (and expectations of inflation) than the real variables cited above. Accordingly, use of market price indicators may in fact result in less volatile markets, less costly outcomes and, consequently, be more appropriate in our current low inflation, high productivity environment.

Finally, a third concern is that the Fed's focus on domestic real economic variables encourages the Fed to downplay important international impacts of its policy moves, which can later feedback onto the economy and create more volatility. Increasingly integrated financial markets, the continuing role of the dollar as the key international reserve currency, and the dollarization that has occurred in recent years all suggest these international impacts may be important. So does accumulating empirical evidence of important impacts of changes in U.S. monetary policy on capital flows and financial markets in emerging market economies. Recognizing the Fed's potential international lender-of-last resort responsibilities also supports the argument that these effects can be important. Stability requires attention to these often neglected effects. This can be accomplished by carefully monitoring and jointly assessing market price indicators such as the dollar exchange rate and commodity prices in the context of a low inflation policy objective.

In sum, these three concerns -- the proper degree of tightening, appropriate policy guides, and recognizing international impacts of policy -- have important implications for market turbulence. If these factors are not taken into account, monetary policy may result in more volatile financial and foreign exchange markets and therefore undermine market efficiency and economic growth. To foster stability and largely avoid further market turbulence, the Federal Reserve should use market price indicators as guides to monetary policy.